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INTRODUCTION

During the closing months of the 1957 session of Congress a bill was introduced in the House of Representatives entitled "A bill to amend the Internal Revenue Code of 1954 to correct unintended benefits and hardships and to make technical amendments." It is better known as the Mills Bill because it was introduced by Representative Mills, the Chairman of the Subcommittee of the House Ways and Means Committee which made the recommendations forming the basis for the bill.

About the time the bill was introduced in the House, the Senate became engaged in a lengthy debate on civil rights and there was no chance of getting the bill enacted in 1957. Under the circumstances, the House deferred action and the bill remained on its calendar for 1958.

The bill does not cover such important areas as corporate distributions and adjustments, estates and trusts, or partners and partnerships. These subjects were assigned to special advisory groups and their recommendations will be the subject for further study by the Committee.

Although the bill may not yet be in its final form, it is important for us to become familiar with the proposals as they stand at the present time. One of the significant features of the bill is the great number of retroactive provisions contained therein. As a matter of fact, the first section states that, unless otherwise expressly provided, all amendments are retroactive to the effective dates or years of the 1954 Code. More than one-half of the 81 sections of the bill are thus to be retroactive to 1954 and many of the remaining sections are to be retroactive to October or November 1956 when the Subcommittee published its first report and held public hearings. Only a few sections are to be effective in 1957 or later, and these will not be covered here.

Whether the delay in the prospective enactment to 1958 will mean that some of the effective dates will be moved forward remains to be seen. In the meantime, careful tax planning must take into account the possibility that many of the retroactive provisions will find their way into the final Act.

PROVISIONS RETROACTIVE TO 1954

Among the provisions which are retroactive to 1954 are some which are purely technical corrections in the wording of the Code and there is no need to go into them here. Some of the more important changes are made to correct unintended results or to clarify the language in order to express the intent of Congress more clearly.

SECTION 5 — DEFINITION OF DEPENDENT

The law allows exemptions for the taxpayer, for his spouse, and for dependents. Among the definitions of a dependent is "an individual who has as his principal place of abode the home of the taxpayer and is a member of the taxpayer's household." Since this definition generally fits a taxpayer's spouse, some people have argued that two exemptions are allowable for the spouse — one as a spouse and another one as a dependent. The committee report states that this was never intended and the wording is changed so that there is to be only one exemption per person. The same paragraph is clarified to the extent that a person is not to be treated as a member of the taxpayer's household if their relationship is in violation of local law. Thus a "common-law wife" cannot be a dependent if the local law does not recognize common-law marriages.

SECTION 10 — CHARITABLE CONTRIBUTION CARRYOVER FOR CORPORATIONS

Corporations are allowed a 2-year carryover of charitable contributions in excess of 5 per cent of taxable income. Because of the interrelationship of this carryover with the net operating loss carryover, a double deduction may result under certain circumstances. The amendment would reduce the contribution carryover to the extent that it is reflected in a net operating loss carryover. The committee report here adds a precautionary note by saying that the amendments made in the bill disallowing double deductions are not intended to imply that in other areas where there may be confusion, double deductions are allowable.

SECTION 17 — PROPERTY RECEIVED IN CERTAIN CORPORATE REORGANIZATIONS; and
SECTION 38 — PROPERTY ACQUIRED IN TAX-FREE EXCHANGE

As mentioned before, sections of the Code dealing with corporate distributions and adjustments are not generally covered by the Mills bill in its present form. One exception is an amendment which would require a downward adjustment in the basis of property where in an otherwise tax-free reorganization or exchange a loss is recognized because the transaction may be regarded as in essence two separate exchanges. Similarly, where property held for productive use in trade or business is exchanged for property of a like kind, and in addition other property is transferred which has depreciated in value, the taxpayer may claim a loss, but the basis of the property received would have to be reduced by the loss.

SECTION 21 — EMPLOYEE STOCK OPTIONS GRANTED BY PARENT OR SUBSIDIARY CORPORATION

An amendment to the restricted stock option provisions clarifies the right of an employee to use these provisions where the option is granted by a parent or subsidiary of the corporation for which he works.

SECTION 24 — ADJUSTMENTS REQUIRED BY CHANGES IN METHOD OF ACCOUNTING

Where a taxpayer changes his method of accounting there always arises the question of what adjustments are required for items of income and deductions which are treated differently under the two methods. For instance, where a change is made from the cash basis to the accrual basis, the Commissioner will want to make sure that items of income which are received in the year of change but accrued in a prior year do not escape taxation. The taxpayer on the other hand does not want to lose a deduction for expenses which accrued but were not paid in a year prior to the change. Conversely, in a change from the accrual basis to the cash basis, the Commissioner will be concerned about the possibility of double deductions and the taxpayer about duplication of income.

The 1939 Code did not contain any specific rules but where a taxpayer was required to ask for permission to change his accounting method, the Commissioner could and did require such adjustments as he considered necessary. However, where the change was initiated by the Internal Revenue Service, the courts generally held that the taxpayer was not required to agree to adjustments affecting prior years which were unfavorable to him.

The 1954 Code laid down specific rules requiring such adjustments as are necessary to prevent amounts from being duplicated or omitted but specifically provided that no such adjustments are required with respect to any taxable year subject to the 1939 Code. No distinction is made here between changes initiated by the Commissioner and by the taxpayer.

The Mills bill would establish this distinction for pre-1954 years. If the change in accounting method is initiated by the taxpayer, the Commissioner would be able to insist on all necessary adjustments, regardless of the year in which the item originated. On the other hand, if the Commissioner initiates the change, adjustments would be authorized only for 1954 Code years.

Where adjustments are required with respect to years prior to 1954 and where taxable income is thereby increased by more than $3,000, a relief provision would allow the spreading of the adjustment over 10 years beginning with the year of change if the taxpayer has been in the same trade or business for that many years prior to 1954. If he has been in that business for less than 10 years, the period over which the adjustment is to be spread is correspondingly shortened. There is to be a further shortening of that period upon death of the taxpayer, termination of a partnership, liquidation of a corporation, or cessation of the business, but in certain corporate reorganizations the spreading of these adjustments could be transferred to a successor corporation.

It is very important to remember that this proposed amendment is to be retroactive for any changes in methods of accounting initiated by a taxpayer for any taxable year beginning with 1954. Any taxpayer who makes such changes without the Commissioner's permission or who has applied or intends to apply for permission should keep in mind that he may have to make pre-1954 adjustments which may not be required if a revenue agent first insists on the change. There is an exception to the retroactivity in the bill in cases where prior to its enactment the taxpayer has applied for a change in method and he and the Treasury Department have reached an agreement as to terms and conditions. It is not likely that there will be many such cases because no regulations have been issued yet on accounting changes and many applications for permission to change are being held up by the Treasury Department.

SECTION 26 — CORPORATIONS IMPROPERLY ACCUMULATING SURPLUS;
SECTION 27 — UNDISTRIBUTED PERSONAL HOLDING COMPANY INCOME; and
SECTION 28 — FOREIGN PERSONAL HOLDING COMPANIES

Charitable contributions are deductible for purposes of the accumulated earnings tax without the 5 per cent limitation applicable for corporation income tax purposes. An amendment in the bill makes it clear that the contribution carryover allowed in the income tax computation should not apply to the accumulated earnings tax, thus eliminating the possibility of a double deduction. Similar amendments are proposed for personal holding companies and foreign personal holding companies.

Another amendment affecting the accumulated earnings tax deals with the treatment of capital gains and the taxes thereon. Under present law capital losses are for the purpose of this tax allowable in full and no capital loss carryover is allowed. In addition, net long-term capital gains (computed without regard to the capital loss carryover) minus the taxes on such gains are eliminated. The amendment makes it clear that the taxes on such gains should be the actual taxes computed after deducting the capital loss carryover rather than the theoretical taxes which would have been paid without regard to the carryover. This amendment works to the benefit of the taxpayer by permitting a larger amount to be eliminated from accumulated taxable income.

SECTION 39 — INVOLUNTARY CONVERSIONS

Where property is involuntarily converted, taxable gain can be deferred if the taxpayer purchases similar property or purchases stock and thereby acquires control of a corporation holding similar property. The 1954 Code inadvertently omitted a definition of control for this purpose which in the 1939 Code was defined as 80 per cent ownership. An amendment in the bill would continue the 80 per cent rule in the 1954 Code.

SECTION 45 — OPTIONS TO BUY OR SELL

The section in the 1954 Code dealing with options to buy or sell has been rearranged and expanded to include several provisions which were intended but not included in the original language. Under present law the section states that sale of or failure to exercise an option to buy or sell a capital asset results in a capital gain or loss, but it does not say that where the asset subject to the option is not a capital asset the result is an ordinary gain or loss. The amended section so provides and it further states that capital gain treatment should not apply to a dealer in options where the option itself is part of his inventory. Also the entire section is not to be applicable to options which result in ordinary income because of other Code provisions such as employees' stock options or stock rights taxable as dividends.

SECTION 47 — REAL PROPERTY SUBDIVIDED FOR SALE

The 1954 Code contained a new section dealing with real estate subdivisions which grants limited capital gain treatment if certain conditions are met. Among these conditions is one which requires that the particular tract or any part thereof must not have been held previously by the taxpayer for sale to customers, and another one that the taxpayer must not during the year of the sale hold any other real property for sale to customers. The original wording of the law made it appear as if only one of these two conditions had to be met. By changing the word "or" to "and" the amendment makes it clear that compliance with both of them is necessary for the section to apply.

SECTION 50 — COMPUTATION OF TAX WHERE TAXPAYER RESTORES SUBSTANTIAL AMOUNT HELD UNDER CLAIM OF RIGHT

A relief provision in the 1954 Code allows a taxpayer who repays an amount which he has previously reported as income to base his tax on a recomputation of the tax for the year in which it was reported instead of taking the deduction in the year of repayment. An amendment in the bill makes it clear that if this is done the item cannot be used in the year of repayment to create a net operating loss carryover or carryback.

SECTION 55 — RETIREMENT ANNUITIES EXCLUDED FROM GROSS ESTATE

For estate tax purposes a limited exemption is allowed for retirement annuity contracts purchased by the decedent's employer. The bill makes it clear that this exemption should apply only if the annuity plan complied with requirements to make it exempt for income tax purposes.

SECTION 63 — RETURNS TREATED AS DECLARATIONS OF ESTIMATED TAX BY INDIVIDUALS

A return filed by a calendar year individual taxpayer by January 31 (or February 15 if he is a farmer) serves as a substitute for an amended declaration of estimated tax which would otherwise be due on January 15. An amendment would extend the same privilege to a fiscal year taxpayer by use of the corresponding dates after the end of his fiscal year.

SECTION 69 — REQUEST FOR PROMPT ASSESSMENT

An executor of an estate or a corporation contemplating dissolution may request prompt assessment of income tax which must then be made within 18 months except in cases of fraud, willful evasion or failure to file a return. Additional exceptions are provided in the bill where 25 per cent or more of the gross income is omitted or where a personal holding company fails to file the required personal holding company schedule with its return. A special 6-year statute of limitations applies in such cases and it would no longer be possible to shorten this to 18 months. On the other hand, the 18-months privilege is to be extended, in addition to corporations contemplating dissolution, to those in the process of dissolution or already dissolved.

SECTION 70 — LIMITATIONS ON ASSESSMENTS AND COLLECTION

Where a corporation determines in good faith that it is tax-exempt and files an information return as such, the statute of limitations starts running even though it is later determined that it is not exempt and should have filed a corporation income tax return. An amendment would extend the same protection to a trust.

Another amendment is intended to restore a provision of the 1939 Code which was inadvertently omitted from the 1954 Code, to the effect that a deficiency attributable to a net operating loss carryback may be assessed within the period of limitation applicable to the loss year.

SECTION 71 — LIMITATION ON CREDIT OR REFUND

The period of limitation for filing a claim for refund is to be changed from 3 years from the due date of the return to 3 years from the time it was actually filed. This would affect only returns filed after the due date, including those filed during a period of extension, since returns filed before the due date would be deemed to have been filed on such date, as they are under present law. The amendment would conform the period for filing claims to that for making assessments.

Another amendment provides that where a return is filed during a period of extension and a claim is filed within 3 years after the return was filed, amounts to be refunded should include not only payments made within the 3 years preceding the date of the claim, as under present law, but those made within that 3-year period plus the period of extension for filing the return.

An inconsistency is to be corrected by making the special period of limitations for filing claims for refund with respect to net operating loss carrybacks end on the 15th day of the 40th month instead of the 39th month in the case of taxpayers other than corporations so as to conform with the change of the filing date from March 15 to April 15.

SECTION 73 — INTEREST ON UNDERPAYMENTS

The section of the Code dealing with interest on underpayments is to be amended to make it clear that such interest might be assessed after the period for assessing the related tax has expired as long as it is assessed and collected during the period in which the tax may be collected.

SECTION 74 — FAILURE TO FILE CERTAIN INFORMATION RETURNS

An amendment to the section imposing penalties for filing information returns removes any basis for contending that the penalty for failure to file such returns could be avoided by filing them after the due date. The present language does not specifically state that failure to file means failure to file on or before the due date.

SECTION 76 — TERMINATION OF TAXABLE YEAR IN CASE OF DEPARTING ALIENS

Departing aliens must procure a certificate that they have complied fully with the income tax laws and they must either pay any income tax due or file a bond or other security to insure payment of this tax. An amendment would give the Secretary of the Treasury the authority to waive these requirements by regulation in cases where it seems appropriate and where it is determined that collection of the tax will not be jeopardized by the departure.

PROVISIONS RETROACTIVE TO 1956

On November 7, 1956 the Mills Committee released a report prepared by the staffs of the Joint Committee on Internal Revenue Taxation and the Treasury Department dealing with unintended benefits or hardships. A number of the changes proposed in that report have found their way into the Mills bill. In order to prevent the use of some of the loopholes before they are closed, many of the proposals are to be made retroactive to years ending after, or transactions taking place after, November 7, 1956. For similar reasons a few of the proposed amendments have been made retroactive to other dates in 1956.

SECTION 3 — DEALERS IN TAX-EXEMPT SECURITIES

Under present law taxpayers in general who purchase tax-exempt State or municipal bonds at a premium must amortize the premium over the life of the bonds and no deduction is allowed for the amortization. The purpose of this is to prevent a deduction for a loss where the premium is really a reduction in the interest income which is tax-free. An exception to this rule is presently made in the case of municipal bond dealers who are not required to amortize premiums on bonds held for 30 days or less, and on bonds whose earliest maturity or call date is more than 5 years from date of acquisition. This provision was intended to prevent undue complications in the accounting procedures of the dealers but the Committee found that some dealers had taken advantage of it by making it a regular practice to buy and sell bonds on which they could take deductible losses offset by nontaxable income. As a result it is proposed to treat dealers the same way as other taxpayers, effective with respect to taxable years ending after November 7, 1956, but only with respect to bonds acquired after that date.

SECTION 11 — LIMITATIONS ON CHARITABLE CONTRIBUTION DEDUCTIONS

A double deduction might be possible through a combination of prepaid interest and charitable contributions. Where a cash-basis taxpayer transfers to a charity property subject to a liability and prepays interest beyond the date of the gift, the interest payment is not only deductible as such but also increases the value of the charitable gift. An amendment would reduce the contribution deduction by the amount of the interest which is applicable to the period after the gift. A similar double deduction could occur where an interest-bearing bond is acquired by a cash-basis taxpayer with borrowed funds and is donated to a charity just before a coupon date. The taxpayer here gets a deduction for interest paid, does not include the coupon in income, and gets a charitable deduction which includes the value of the coupon. An amendment here would reduce the charitable deduction by the amount of the interest paid to the extent of the coupon interest which accrued prior to the gift but was not included in income.

Both of these changes are to be effective with respect to contributions made after November 7, 1956.

SECTION 12 — AMORTIZABLE BOND PREMIUM

The 1954 Code attempted to close a loophole by which a taxpayer who bought a callable bond at a premium could amortize the premium against ordinary income to an early call date, and if the bond was not called he could sell it and realize a capital gain. However, this loophole remained open for bonds issued on or before January 22, 1951 and for bonds with the earliest call date more than 3 years from the date of issue. The bill now proposes to close this loophole further for any taxable bonds acquired after November 7, 1956 by requiring amortization of the premium to the maturity date rather than a call date, unless amortization to a call date results in a smaller deduction.

SECTION 16 — DEDUCTIONS BY CORPORATIONS FOR DIVIDENDS RECEIVED

The 85 per cent dividends-received deduction allowed to corporations results in dividend income usually being taxed at a maximum rate of only 7.8 per cent (15 per cent of 52 per cent). If stock in a corporation paying a dividend is purchased by another corporation shortly before the ex-dividend date and sold shortly after such date, frequently a short-term capital loss in the approximate amount of the dividend will result. Such loss may result in a tax saving of 52 per cent if it offsets a short-term gain or of 25 per cent if it offsets a long-term gain, thus reducing the tax considerably even though no real loss has been incurred. To avoid this result, the bill would disallow the dividends-received deduction if the stock is held for a period of 10 days or less before it is sold. If the stock is preferred stock and the dividend covers a period of more than 366 days, the period is to be extended from 10 to 90 days. The deduction is also to be disallowed if the corporation carries a short position in the same or substantially identical stock over the ex-dividend date. Special rules would provide for determining the holding period of the stock. The new rule is to be effective for stock acquired after November 7, 1956.

SECTION 22 — VARIABLE PRICE RESTRICTED STOCK OPTIONS

A variable price restricted stock option is one under which the purchase price is determined by a formula in which the only variable is the value of the stock within a 6-month period which includes the date the option was exercised. Such an option qualifies as a restricted stock option if the option price would be at least 85 per cent of the value of the stock if the option were exercised at the time it is granted. Under this formula it is possible for a company to give its employees more of a bargain than was intended when the law was written where the price of the stock has declined considerably during a short period of time. For example, if the price has dropped from $150 to $100 in a 2-month period an option can be granted with a formula providing for an option price of 56.7 per cent of the market value 2 months before exercise of the option, because 56.7 per cent of $150 is $85. Then if the market price remains at $100 for 2 months the option could be exercised at $56.70. To prevent this, the bill would have an option granted after November 7, 1956 disqualified as a restricted stock option if the option price is determined by the value of the stock at any time before the option is exercised and if such value may be greater than the average value of the stock during the calendar month in which the option is exercised.

SECTION 25 — DENIAL OF EXEMPTION TO ORGANIZATIONS ENGAGED IN PROHIBITED TRANSACTIONS

An exempt pension trust may not lend under present law any part of its income or corpus without adequate security to the employer corporation. The proposed regulations interpret this provision to prohibit the investment of funds in unsecured bonds of the employer corporation but the rule has not been issued in final form pending further study of the problem. The Mills Committee feels that rule is too restrictive and its bill would permit such investment as long as the price paid for the bonds is not higher than would be paid in an arms-length transaction, the trust owns not more than 25 per cent of any issue, at least 50 per cent of the issue is held by persons independent of the employer, and not more than 25 per cent of the assets of the trust are invested in bonds of the employer. Furthermore, bonds acquired after November 8, 1957 would have to be issued under an agreement that, if the employer subsequently mortgages substantially all its property, the bonds will be given a preference no less favorable than that afforded the other obligations. In general, the effective date of this provision is to be for taxable years ended after March 15, 1956, but this will not prohibit any transaction which was not prohibited under previous announcements by the Internal Revenue Service.

SECTION 28 — FOREIGN PERSONAL HOLDING COMPANIES

Two amendments affecting foreign personal holding companies are to be effective for years ending after October 31, 1956. The first one is to prevent a double deduction for partially tax-exempt interest by allowing it only to the domestic shareholders and not to the foreign personal holding company. The second amendment provides that the net operating loss deduction is to be computed without taking into account the dividends-received deduction and other special deductions which are not allowed in computing foreign personal holding company income. A provision similar to this last amendment would be made for personal holding companies, but in their case it would not be made retroactive to years prior to 1957.

SECTION 34 — TRANSACTIONS IN REGULATED INVESTMENT COMPANY SHARES AROUND TIME OF DISTRIBUTING CAPITAL GAIN DIVIDENDS

Capital gain dividends paid by regulated investment companies are taxable to the shareholders as long-term capital gains. If stock in such companies is purchased just before the ex-dividend date and sold shortly thereafter it is possible to sustain a short-term capital loss or, in the case of a dealer in such stock, an ordinary loss equivalent to the capital gain dividend. This tax advantage without an economic loss is to be prevented for stock acquired after November 7, 1956 by treating any loss to the extent of the capital gain dividend as a long-term capital loss if the stock is held for less than 31 days.

SECTION 42 — BONDS ISSUED AT DISCOUNT

The 1954 Code provisions on original issue discount were designed to end the practice of issuing bonds at a discount with no interest or a low interest rate and allowing the holders to claim a capital gain on sale or redemption of the bonds. A gain equal to the proportionate part of the original issue discount attributable to the period the bond is held is now treated as ordinary income, but it is still possible to claim a capital gain where the gain exceeds such portion of the discount. To prevent advantage being taken of this capital gain treatment by issuing bonds at artificially large discounts and redeeming them at par or at a call price before maturity, an amendment applicable to bonds sold after November 7, 1956 would require a holder to report his gain as ordinary income to the extent of the entire original issue discount regardless of the period he held the bond.

SECTION 43 — BONDS WITH COUPONS DETACHED

The 1954 Code provides that if bonds are purchased at a discount because any of the coupons have been detached which are attributable to a period more than 12 months in the future, the resulting gain on the sale of the bonds is treated as ordinary income. An amendment applicable to bonds purchased after November 7, 1956 would extend this provision to bonds with any future coupons detached, including coupons payable within the next 12 months.

SECTION 44 — SHORT SALES

The section in the 1954 Code dealing with short sales is designed to prevent the use of short sales to change short-term capital gains into long-term gains and long-term losses into short-term losses. However, under present law this result is not accomplished if a dealer uses inventory securities to close a short sale. Under an amendment in the bill a dealer would be governed by the same rules as if he had used a capital asset to cover a short sale made after October 24, 1956. Another amendment would exempt hedging transactions in commodity futures entirely from the short-sale rules of the 1954 Code.

OTHER RETROACTIVE PROVISIONS

A few sections of the bill have effective dates other than in 1954 or 1956.

SECTION 53 — PERIOD OF LIMITATION FOR FILING CLAIM FOR CREDIT FOR STATE DEATH TAXES

In a federal estate tax return a credit is allowed for state death taxes if they are paid within 4 years from the time the federal return is filed or within 60 days after a Tax Court decision becomes final. If instead of filing a petition with the Tax Court the taxpayer pays the disputed tax and files a claim for refund, present law does not provide for an extension of time for paying state death taxes and taking credit therefor. An amendment provides that in such cases the time would be extended to 60 days after the claim is disallowed or 60 days after a final decision of a court acting upon the claim. This is the most retroactive provision in the bill since it also amends the 1939 Code and applies to estates of decedents dying after February 10, 1939.

SECTION 57 — GIFT TAX NOT TO APPLY TO ELECTION OF SURVIVOR BENEFITS UNDER CERTAIN QUALIFIED PLANS

An amendment to the gift tax provisions would exempt from gift tax an election by a beneficiary of a qualified employees' pension plan to have benefits paid to a survivor beneficiary, except to the extent that such benefits are attributable to the employees' own contributions to the plan. This amendment would make the gift tax rule conform to the corresponding estate tax provisions and would be effective for 1955 and subsequent years.

SECTION 81 — INCOME TAXES PAID BY LESSEE

The 1954 Code in effect restored a rule which had been in effect prior to 1952 and which prevented the pyramiding of tax on tax where a lessee agrees to pay as part of the rent the lessor's income tax on the rent income. A proposed amendment to the 1939 Code would close the now existing gap by extending the law in effect prior to 1952 to the years 1952 and 1953.

CONCLUSION

The report issued by the Mills Committee in November 1956 contained a number of proposals which were omitted from the bill introduced in the House. Some of these proposals may still be added to the bill before it becomes law, and if so, there may be more retroactive provisions. Whether this will be so is impossible to tell at the present time.